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In the Supreme Court of the United States

OCTOBER TERM, 1941

NO. 225.

H. H. WEGENER,
Petitioner,

VERSUS

GUY T. HELVERING, Commissioner
of Internal Revenue,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

PETITION FOR WRIT OF CERTIORARI

TO THE HONORABLE SUPREME COURT OF THE UNITED STATES:

Your petitioner respectfully shows:

I.
SUMMARY STATEMENT OF MATTER INVOLVED

This case was begun in the Board of Tax Appeals. It involves an asserted deficiency in petitioner's income tax for the calendar year 1935 of $13,347.99. Substantially all of this resulted from the inclusion in petitioner's income of the sum of $23,592.08 alleged to be profit or gain realized

from drilling oil wells on leaseholds in Rusk County, Texas, owned by him and Walter H. Gant and Knox L. Garvin as tenants in common in equal undivided interests. The above item is one third of the amount by which the total price for drilling the wells on a footage basis as agreed on between petitioner and Gant and Garvin exceeded his actual cost in drilling them. He returned the other two thirds of such excess as income and paid tax on it. The Commissioner held that petitioner and Gant and Garvin constituted a *partnership* and that in drilling the wells he dealt with the partnership as a business unit and made the above profit on the well drilling contract, notwithstanding he owned an undivided one-third interest in the leaseholds and contributed from borrowed money one third of the so-called partnership capital out of which the amount of the footage price for the wells was paid to him. The Board held that petitioner and Gant and Garvin constituted a *joint venture* in their cooperative development and operation of their separately owned interests in the leases and upon such holding reached the same conclusion as the Commissioner. 41 B. T. A. 857. The petitioner took the case to the Circuit Court of Appeals for the Fifth Circuit for review of the Board's decision and that Court affirmed the Board. 119 Fed. (2d) 49.

The petitioner will be referred to herein as petitioner or taxpayer or by name. All italics are ours unless otherwise indicated.

The Facts

The petitioner now resides at Dallas, Texas, but in 1935 and prior years he resided and had his principal place of business in Oklahoma City, Oklahoma (R. 26). Early in 1932 Walter H. Gant and Knox L. Garvin began negotiating for certain oil and gas leases owned by the Reliance Oil & Royalty Corporation and others in Rusk County, Texas. Under date of February 23, 1932, they acquired those leases by assignment and conveyance from the owners for the consideration of drilling wells thereon and paying certain sums out of oil production therefrom as set out in the assignment, which appears in full, except for description of the real estate, signatures and acknowledgments, in the record (R. 99-113).

Wegener was engaged in the business of drilling oil wells and had suitable equipment and an employee organization for that purpose. He also had financial credit which Gant and Garvin did not have. Early in 1932 Garvin invited Wegener to take a one-third interest in the leases, and this Wegener later did (R. 47-55).

Since the character of the relationship between petitioner and Gant and Garvin in the development and operation of these leases is of importance, that part of the record covering the expressed intention of the parties themselves on that point is set out in full.

Wegener said:

"He had told Garvin when he acquired an interest in the leases that *he did not want to be a partnership, because he had experience with partnerships and did*

not like them. He understood the liabilities of a partnership and the responsibilities of the members toward each other *and knew that if a partner died the partnership would be tied up, but if there was no partnership, the owners could carry on their business. Garvin explained that they would not have a partnership*" (R. 47).

The witness Miller said:

"Along in January, 1932, Garvin came to his office and met Wegener, and Garvin told Wegener that he had gotten the Rusk County block, and Wegener said he would take a third interest in the block. They discussed the relationship and manner of handling the deal and Wegener said he would take a ⅓ interest 'in these leases but not as a partnership deal, *that he didn't want to be in partnership with anybody,*' and also told Garvin *that he didn't want an interest in any property which he could not sell when he wanted to*" (R. 55).

And again:

"Witness had a conversation with Gant in August, 1936, in which Gant said that he had understood from the first, and *he and Garvin and Wegener had definitely agreed from the first, that their operations would not be a partnership proposition*" (R. 57).

The witness Gant said:

"He lived in Ardmore, Oklahoma, and was the Walter H. Gant interested in the Rusk County leases.

"He had heard Mr. Miller's testimony about a conversation between them in August, 1936, and it was correct. *Garvin, Wegener and he had never had an agreement to operate as a partnership or to be a part-*

nership. They had a conversation which 'worked itself into an assignment' of one-third to Wegener at about the time he and Garvin acquired those leases, but 'there was no understanding that there would be a partnership.' *Everything had to be agreed upon unanimously and they always consulted before anything was done.* He always understood *that he held a 'third interest' in the Rusk County leases and he regarded this as his individual property, subject to his right to assign or convey.*

* * * * * * *

"He, Garvin and Wegener each owned a third interest in the Rusk County leases. Wegener got his one-third interest by agreement before any development took place and the written assignment to him followed later. *Each was to get his part of the returns from oil runs from the pipe lines individually, and it was to be on the basis of ⅓ each*" (R. 60-61).

The witness Cund, who had been Garvin's attorney for a period of years, said:

"He knew Gant and Garvin had been partners for several years in some of their Oklahoma operations, and in the conversation about the Texas properties Garvin had explained why they were selling Wegener 'an undivided one-third interest in the property,' '*because they thought he was financially able to help them borrow money to be used in the development of the property,*' and had said 'it wasn't *to be a partnership like he and Mr. Gant had in their operations in Oklahoma.*' Garvin did not state to him what the character of the arrangement was to be other than a one-third interest. He had told Garvin 'that *they might act in such manner, jointly owning the property, that the law might make it a mining partnership*'" (R. 62).

The witness Smilie, an accountant living in Oklahoma City, said:

> "He never had a conversation with any of the three gentlemen (Gant, Garvin or Wegener) with respect to their relation to each other in the development of the Rusk County, Texas leases, but was present when Revenue Agent Sullivan was examining petitioner's 1935 return and heard a conversation between Sullivan and Garvin and heard Garvin tell Sullivan that *'he had never considered Gant, Garvin and Wegener as a partnership,'* and that some of their acts 'might have bound them jointly,' and 'they might have appeared to be partners, but *it wasn't his intention ever to be a partner'* " (R. 67).

Garvin died prior to the trial before the Board and the only evidence available of his intention was statements he had made.

After Wegener had orally agreed that he would take a one-third interest in the leases, he drilled some seven or eight wells on them in 1932 at a price per foot agreed upon between him and Gant (R. 47, 55). He billed Gant and Garvin for two thirds, or each of them for one third, of the agreed price of these wells, which exceeded their actual cost, and charged himself with one third of his actual cost in drilling them (R. 47, 53, 55).

On July 7, 1932, another agreement was entered into between the assignors of these leases and Gant and Garvin which amended, supplemented and modified the original contract of assignment. This, omitting signatures and acknowledgments, appears in full in the record (R. 113-119). On September 15, 1932, a further agreement was

entered into between the same parties amending the previous agreements of February 23 and July 7, 1932 (R. 69-70). On October 31, 1932, pursuant to their previous oral agreement Gant and Garvin assigned to petitioner an undivided one-third interest in the leases so acquired by them from Reliance Oil & Royalty Corporation and others. The habendum clause of this assignment reads as follows:

> "To have and to hold said undivided one-third (⅓) interest in and to said above described oil and gas leases, and said rights, options and privileges, unto the said H. H. Wegener, his heirs and assigns" (R. 84).

The assignment further provided:

> "The undivided one-third interest in and to the said above described oil and gas leases herein assigned unto the said H. H. Wegener is chargeable with one-third of all oil considerations payable to said Reliance Oil and Royalty Corporations, etc. (R. 85).
>
> * * * * * * *
>
> "By the acceptance of this assignment said H. H. Wegener assumes one-third of all duties, obligations and liabilities imposed upon the said Walter H. Gant and Knox L. Garvin in that certain original contract executed by Reliance Oil & Royalty Comporation, etc.
>
> * * * * * * *
>
> "And the ⅓rd interest in and to the said above described oil and gas leases herein assigned to the said H. H. Wegener, shall be and remain jointly and severally liable with the ⅔rds interest in said above described oil and gas leases retained by the said Walter H. Gant and Knox L. Garvin for the payment of all oil and money considerations payable to the said Reliance Oil & Royalty Corporation, etc." (R. 88).

One issue before the Board was whether Gant, Garvin & Wegener were a general partnership in the development and operation of the oil leases above referred to. The Board found as a fact that they were not a general partnership, but that their operations were a joint venture. The petitioner contends that they were a mining partnership which, if it be deemed a species of joint venture, has some characteristics distinct from an ordinary joint venture. The Board recognized that they owned the leases in undivided one-third interests (R. 25). This necessarily made them owners of those leases as tenants in common.

By reason of the Board's holding that they were not a general partnership, the references to them as partners or a partnership in the various instruments introduced in evidence may be understood to refer, and properly under all the evidence should be deemed to refer, to them as mining partners and a mining partnership.

About September 1, 1932, Miss Boone, a bookkeeper in the employ of Gant, opened a set of books on the leases here involved in the name of Gant, Garvin and Wegener, a partnership, and kept them in Gant's office at Ardmore, Oklahoma (R. 65-66).

In 1932 Miller, of the accounting firm which kept Wegener's books, told him and Garvin that it would require much unnecessary detail during the period of development to keep three sets of books on those leases and recommended a joint set of books, which should be so kept that when the development period was over each could take up one third of each item on his individual books and dispense

with the joint books. Up to that time, the accounts for the drilling were kept on Wegener's individual books on which he charged Gant and Garvin with two thirds of the amount of the agreed price for the wells and himself with one third of their cost (R. 55).

After Miller learned that the Gant, Garvin and Wegener books had been opened in Gant's office, he had Wegener bill 100% of the amount for drilling the wells computed on the agreed footage basis and charge this total to an account of Gant, Garvin & Wegener on his books and credit an account called "Lease Investment Contra" with one third of the profit. He personally prepared some of these bills in 1935 and instructed Wegener to set out full details on his tax return to show the segregation of one third of the profit in these transactions, because he was dealing with himself and couldn't be his own employer (R. 55-56).

The figure of $130,594.50 under Item 2(b) of Wegener's return (R. 82) for 1935 represented the total number of feet drilled at the agreed rate per foot. In setting up Wegener's books so they would show comparative data on drilling operations from year to year, the total so computed in each year would be set up as the gross from contracting, but he would be entitled to receive only the two thirds of it that came from Gant and Garvin (R. 57). Of this sum of $130,594.50 for 1935 computed at the agreed footage rate, $70,726.23 represented the excess of the agreed price over cost and one third was payable by Wegener to himself and two thirds by Gant and Garvin to Wegener (R. 57). *All of this $130,594.50 which Wegener received for drilling in*

1935 was paid to him out of money borrowed by Gant, Garvin & Wegener in that year (R. 56). The Board specifically found this to be the fact (R. 29).

Homan, also of the accounting firm which kept Wegener's books, said that until the fall of 1932 Gant and Garvin were charged on his books with two thirds of the expenditures for equipment on the leases and he was charged with one third. Referring to the "Lease Investment Contra" account in Wegener's ledger, of which the first entry was November 30, 1932, and the last December 1, 1937, he said this account was opened at his direction and the first three entries were in his handwriting, and that it was an account to contain, as a credit item, the difference between the actual cost of drilling the wells, and the amount at which they were charged to Gant, Garvin and Wegener and set up on their joint books, and that, "It would have been difficult to keep on Mr. Wegener's books his one-third of the cost of each of these wells and each item in the cost and to have, on another set of books for Gant and Garvin, each one third of the cost, or on the partnership books of Gant and Garvin, two-thirds of the cost," and "so for convenience, and to check the settlement of Gant and Garvin with Wegener individually, they were set up on the joint books at Ardmore at the agreed price per foot."

Originally the "Lease Investment Contra" Account showed "The entire difference between Wegener's cost and the price based on a footage rate," but "after settlement of the 1932 income tax case with the Revenue Agent it was reduced to one-third and since 1932, these figures reflect

Wegener's one-third of the so-called profit." He said the words "Lease Investment Contra" were "to indicate it was to be used as a credit balance account to reduce the other account in which the investment is carried," and under that caption was written "Reduction of H. H. Wegener's cost of one-third interest in Gant, Garvin & Wegener joint venture" (R. 64-65). "This was to take care of the difference in the cost of his one-third between what was billed on these statements and what it actually cost him" (R. 65).

Miss Boone, an employee in Gant's office in charge of the accounts and books of the business, caused letterheads to be printed bearing the names of "Gant, Garvin and Wegener," and used them in her correspondence. She did this without any instructions from either Gant, Garvin or Wegener and because she felt that separate letterheads would help keep the accounts of that business separate from those of various other properties she was handling (R. 66). It does not appear that these letterheads are of any significance, though the Board and the Court refer to them (R. 28, 141). Wegener said he had seen them, but never had used one (R. 51).

All payments to Wegener were from money borrowed by the three of them and paid into their joint account. He said:

> "They borrowed money at the bank and 'my check and Mr. Gant's check and Mr. Garvin's check' for oil runs 'all went into the bank to pay off this note we had signed.' These checks didn't come in payable to Gant,

Garvin & Wegener, but were separate checks to each individual" (R. 53).

The first money borrowed was from the First National Bank & Trust Company of Oklahoma City on October 17, 1932 (R. 54), to secure the payment of which they gave their mortgage or trust deed covering their leases (R. 95-97). This instrument recites that "H. H. Wegener, Walter H. Gant and Knox L. Garvin each own an undivided one-third interest in and to the property, etc." (R. 96). It secured an $80,000 note which the three of them signed at that time and also secured a $99,000 note of Gant and Garvin, not signed by Wegener and for the payment of which no part of his interest in the leases and the oil runs was pledged (R. 94-97).

On January 5, 1934, they borrowed $10,000 from the Sun Oil Company and then borrowed additional sums from that company on February 12, 1934, February 16, 1934, and March 22, 1934. Each sum borrowed was secured by a trust deed covering their oil property and a pledge of their oil runs (R. 72-73). On September 12, 1934, Gant and Garvin as individuals gave a trust deed on their undivided two-thirds interest in the leases to secure a loan of $50,000 from the First National Bank & Trust Company of Oklahoma City. It does not appear whether this was a loan of that sum at that time or was given to take up a previous loan. *It is significant that Wegener was not a party to this transaction and that the instrument purported to cover the undivided two-thirds interest of Gant and Garvin in the leases* (R. 73-76).

On August 13, 1935, Gant, Garvin and Wegener as a partnership and as individuals borrowed $300,000 from the National Bank of Tulsa and gave their trust deed covering the leases and pledged their oil runs to secure the payment thereof (R. 89-94). In respect of these borrowings Wegener's testimony was that:

> "After they borrowed money at the Exchange National in Tulsa the checks for runs went there until the notes were paid off and the same was true as to the money they borrowed from the Sun Oil Co." (R. 53.)

The witness Miller testified:

> "He was present with Wegener and Garvin, at Ardmore on August 26, 1935, when Wegener got a check for $76,000, which was his first payment on the drilling, out of the $300,000.00 borrowed from the Tulsa Bank [R. 89-94]. The money Wegener got in payment on his drilling of the wells was from loans, and he pledged his ⅓ interest in the oil runs for repayment of the loans and the money from the oil runs went direct to the lenders and, except for enough allowed the borrowers for operating expense, was applied to pay off the loans.
>
> "In November, 1935, Gant, Garvin and Wegener borrowed another $100,000.00 from the Tulsa bank and Wegener got $25,000.00 out of that, and in December, 1935, they borrowed some more money from the Sun Oil Co., and Wegener got $34,000.00 out of that" (R. 56).

In its findings of fact the Board says:

> "In order to finance the development and operation of the leases, it was necessary to borrow money from time to time and oil runs were pledged to repay the loan" (R. 27).

And again:

"In 1935 Gant, Garvin, and Wegener, as a co-partnership and as individuals, secured loans from the National Bank of Tulsa, Tulsa, Oklahoma, in the amount of $300,000 and assigned to F. M. Sowle, as trustee, the Rusk County leases as security for the loan. Other loans were made during the year. The money in payment of the oil runs went to the bank to liquidate the loans and the bank turned over to the joint account enough money to pay the current operating expenses. *Petitioner was paid for drilling from the money borrowed from time to time.* It was understood that he would receive the full amount of the footage rate for drilling wells" (R. 28-29).

It will be noted that payments made to Wegener were *solely for drilling the hole on a footage basis* (R. 47). All physical equipment required to complete a well, as casing, connections, surface lines, separator, flow tanks, etc., was obtained from some other source.

Gant, Garvin and Wegener filed a return on Form 1065 for each of the years 1932, 1933, 1934 and 1935. This form is entitled "Partnership Return", but is the only form of return provided for use by a group organization such as a "partnership, syndicate, pool, joint venture, etc." The year 1932 showed a loss and all the others a profit. The net income for 1935 was $55,680.67 and was distributed in equal parts to the three members of the organization (R. 48-49). Wegener included his one third of the profits in income on his return for each year and paid the tax thereon. The amount thus returned and upon which tax was paid for 1935 was $18,560.22 (R. 29, 49-51). He also included in in-

come on his 1935 return the sum of $47,184.50 as received from Gant, and Garvin for drilling wells. This was two-thirds of the $70,776.23 by which the $130,594.50 received from the joint account of Gant, Garvin and Wegener exceeded the $59,818.27 which it cost him to drill the wells and was the portion of that excess allocated to Gant and Garvin (R. 29). *The partnership returns did not in any year show any expenditure of the partnership for drilling wells nor any capital investment in them nor take any deduction for drilling them.*

The Board of Tax Appeals held that Gant, Garvin and the petitioner in their operation of developing their leases constituted a joint venture and a partnership within the provisions of the applicable Revenue Act, and that petitioner was required to include in his income subject to taxation the full $70,776.23, of difference between the $130,594.50 received by him and his cost of $59,818.27, as gain derived from the drilling of wells for the alleged joint venture as though it were a distinct and opposite contracting party in which he had no interest and was itself the owner of the leases, and further held that even though ⅓ of the $70,776.23, being the sum of $23,592.08, was paid to him out of his capital investment in the alleged joint venture or partnership and out of his share of the capital assets thereof, still the same was taxable gain to him, because, as the Board asserted, he had by that payment merely changed his share in the cash capital assets of the alleged joint venture or partnership into an equal share in its capital assets consisting of oil wells. Pursuant to its holdings the Board rendered

a decision and final order of redetermination adjudging a deficiency in tax against the taxpayer for the year 1935 in the sum of $13,347.99.

The court below followed the Board's reasoning and affirmed its decision, Judge Hutcheson dissenting in a vigorous opinion (R. 139-151).

II.
JURISDICTION

1. The date of the judgment of the Circuit Court of Appeals to be reviewed is April 7, 1941 (R. 151). The opinion of the Court was handed down on the same day (R. 139).

2. The statutory provision under which the jurisdiction of this Court is invoked and which is believed to sustain its jurisdiction is Section 347(a) of Title 28 of the United States Code, being Section 240 of the Judicial Code, as amended.

3. The decision of the court below is in conflict with the decisions of various Circuit Courts of Appeals and of this Court, and decides an important question of federal law which has not been, but should be, settled by this Court, and decides an important question of the local law of Texas in a way in conflict with the applicable decisions of the courts of that State, and decides an important question of general law in a way in conflict with all authority. This Court entertains jurisdiction to grant writs of certiorari in similar cases at every term, and there can be no need to list

any of the great array of cases in which its jurisdiction is so exercised.

4. The petition for the writ is presented under Rule 38, paragraph 5(b), of the Revised Rules of this Court adopted February 13, 1939, and effective February 27, 1939.

III.
QUESTIONS PRESENTED

The questions presented on this petition may be stated as follows, the answers to the first three being preliminary, but perhaps not essential, to the answer to the fourth:

1. Were the petitioner and his associates in their joint operations in the development of their oil and gas leases a joint venture or a mining partnership?

2. If a joint venture, were the oil and gas leases capital assets of the venture as a legal entity or business unit separate and distinct from its members?

3. If so, is a payment to petitioner made out of capital assets of such venture and a repayment in part of money which he had paid into its capital, profit and taxable gain to him?

4. Where petitioner drilled wells on oil and gas leases owned by him and two associates, either individually in undivided interests of one third each or as a mining partnership or joint venture in which each owned a one-third interest, and one third of the cost of the wells was to be borne by each, either directly, or indirectly as a member of

the mining partnership or joint venture, and a price was agreed on between petitioner and his associates for the drilling of the wells and he was paid this price out of money they had borrowed and placed in a joint account, one third of which as between themselves was the debt of each, either directly, or individually as a member of the mining partnership or joint venture, and the price thus paid to petitioner exceeded his actual cost in drilling the wells, two-thirds of which excess in price over cost he included in income on his tax return: Is the remaining one third of this excess in agreed price over actual cost so paid to petitioner a return in part of the capital sum he paid into the joint account, or is it a new acquisition and taxable gain to him under the income tax statutes?

IV.
REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT

The petitioner relies on the following reasons for the allowance of the writ of certiorari:

1. The Circuit Court of Appeals, in holding that, as a matter of law upon the undisputed facts Gant, Garvin and Wegener in their joint operations in the development of their Rusk County, Texas, oil and gas leases constituted that form of a restricted general partnership known as a joint venture, has rendered a decision in conflict with the decision of the Circuit Court of Appeals for the Third Circuit in *First Mechanics Bank* v. *Commissioner*, 91 Fed. (2d) 275,

and as well in conflict with all text writers and with all other court decisions, on the same matter.

2. The Circuit Court of Appeals, in holding that as a matter of law upon the undisputed facts, Gant, Garvin and Wegener in their joint operations in the development of their Rusk County, Texas, oil and gas leases did not constitute a mining partnership, has rendered a decision on a question of general law in conflict with the applicable decisions of this Court in *Kahn* v. *Central Smelting Company*, 12 Otto (102 U. S.) 641, and in *Bissell* v. *Foss*, 114 U. S. 252, and in conflict with all text writers and all other court decisions, on the same matter, and has decided an important question of local law in the State of Texas in a way in conflict with the law of that State as declared in 29 Texas Jurisprudence 698, and in the decisions of the courts of that State in *Adams* v. *Texhoma Oil & Refining Co.* (Tex. Civ. App.), 262 S. W. 139, 141, and *Munsey* v. *Mills & Garitty*, 115 Tex. 469, 283 S. W. 754.

3. The Circuit Court of Appeals in holding that petitioner as an individual drilled oil wells for Gant, Garvin and Wegener as a business unit and independent opposite contracting party, and not for himself as to his one-third interest in the wells and leases and for Gant and Garvin as to their two-thirds interest therein, but just as any outsider might have drilled the wells for Gant, Garvin and Wegener as a business unit, has rendered a decision in conflict with the decision of the District Court of the United States for the Northern District of Ohio in *United States* v. *Coulby*, 251 Fed. 982, and with the decision of the United

States Circuit Court of Appeals for the Sixth Circuit in *United States* v. *Coulby*, 258 Fed. 27, and with the decision of the Court of Claims in *Craik* v. *United States*, 31 Fed. Supp. 132, and with its own decisions in *Carroll* v. *Commissioner*, 70 Fed. (2d) 806, and *Jennings* v. *Commissioner*, 110 Fed. (2d) 945, and with the applicable decision of this Court in *Neuberger* v. *Commissioner*, decided November 12, 1940, and not yet officially reported, but reported in 61 Sup. Ct. 97.

4. The Circuit Court of Appeals in deciding that the amount received by petitioner out of capital assets of Gant, Garvin and Wegener in excess of one third of his actual cost in drilling the oil wells on the oil and gas leases involved, being the sum of $23,592.08, was not a repayment of a part of the cash capital he had paid into Gant, Garvin and Wegener, but was a new acquisition and was profit and taxable gain to him, has rendered a decision in conflict with the Treasury Ruling in General Counsel's Memorandum 6582, Cumulative Bulletin VIII-2, 200, and with the decisions of the Board of Tax Appeals in *Leo Schwartz*, 7 B. T. A. 223, *S. U. Tilton*, 8 B. T. A. 914, *Augustine M. Lloyd*, 15 B. T. A. 82, and *Melville W. Thompson*, 18 B. T. A. 1192, and in conflict with the court decisions cited in the preceding paragraph, and in conflict with (quoting Judge HUTCHESON in his dissenting opinion) "everything that has been written and said in taxing statutes and decisions relating to and affecting partners and partnerships and their return and payment of income taxes" (R. 150), and has decided an important question of Federal law in respect of income taxation which has not been, but should be, settled by this Court.

Wherefore, your petitioner prays that a writ of certiorari be issued under the seal of this Court directed to the United States Circuit Court of Appeals for the Fifth Circuit at New Orleans, Louisiana, commanding said Court to certify and send to this Court a full and complete transcript of the record and of the proceedings of said Court had in cause No. 9693 in said Court, entitled *H. H. Wegener, petitioner,* v. *Commissioner of Internal Revenue, respondent,* to the end that said cause may be reviewed and determined by this Court as provided by the statutes of the United States, and that the judgment of said United States Circuit Court of Appeals in said case be reversed by this Court, and that petitioner have such further relief as to this Court may seem proper.

Dated at Oklahoma City, Oklahoma, this 25th day of June, 1941.

H. H. WEGENER,
Petitioner,

By CHAS. H. GARNETT,
608 Hales Building,
Oklahoma City, Oklahoma,

C. F. MILLER,
415 Liberty Bank Building,
Oklahoma City, Oklahoma.

Counsel for Petitioner.

In the Supreme Court of the United States

OCTOBER TERM, 1941

NO. . . . . .

H. H. WEGENER,
Petitioner,

VERSUS

GUY T. HELVERING, Commissioner
of Internal Revenue,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF IN SUPPORT OF PETITION

I.

OPINIONS IN COURTS BELOW

This case originated in the United States Board of Tax Appeals. From a decision of the Board adverse to petitioner he took the case for review to the Circuit Court of Appeals for the Fifth Circuit. That Court affirmed the Board. The opinion of the Board is reported in 41 B. T. A. 857, and the opinion of the Court below is reported in 119 Fed. (2d) 49.

II.
STATEMENT OF THE CASE

A statement of the case containing all that is material to the consideration of the questions presented with appropriate page references to the printed record has been made in the petition for the writ and such statement is hereby adopted and made a part of this brief.

III.
ASSIGNMENT OF ERRORS

The petitioner makes the following assignment of errors committed in the opinion and decision of the Court below:

1. The Circuit Court of Appeals erred in holding that Gant, Garvin and Wegener in their joint operations in the development of their Rusk County, Texas, oil and gas leases constituted that form of a restricted general partnership known as a joint venture.

2. The Circuit Court of Appeals erred in not holding that Gant, Garvin and Wegener in their joint operations in the development of their Rusk County, Texas, oil and gas leases constituted a mining partnership.

3. The Circuit Court of Appeals erred in not holding that Gant, Garvin and Wegener at all times owned as individuals an undivided one-third interest each in their Rusk County, Texas, oil and gas leases and that the use only of those leases was contributed to the joint enterprise

of their development in the name of Gant, Garvin and Wegener, whether such enterprise was a joint venture or a mining partnership.

4. The Circuit Court of Appeals erred in holding that the Rusk County, Texas, oil and gas leases were capital assets of Gant, Garvin and Wegener as a joint venture and business unit and legal person apart from and independent of the natural persons composing it, and that Wegener drilled wells on its leases under agreement with it as an independent opposite contracting party and not for himself as to his one-third interest in the wells and leases and for Gant and Garvin as to their two-thirds interest therein.

5. The Circuit Court of Appeals erred in holding that petitioner drilled wells for Gant, Garvin and Wegener as a business unit and independent opposite contracting party just as any outsider might have done with that organization and that all of the cash payment at the agreed price for drilling the wells received by him in excess of his actual cost in drilling them was a net profit, as though he had no interest in that organization had dealt with it as if it were a natural person or a corporation.

6. The Circuit Court of Appeals erred in not holding that one third of the amount the petitioner received from the joint account of Gant, Garvin and Wegener in excess of his cost in drilling the wells was in fact a payment made to himself out of cash paid by him as capital into said joint account, and that it was not a new acquisition or profit or gain to him.

7. The Circuit Court of Appeals erred in not holding that the sum of $130,594.50 paid to Wegener out of the money borrowed by him and Gant and Garvin and paid into their joint account was a distribution to the three of them in equal parts of paid in capital of their joint enterprise.

8. The Circuit Court of Appeals erred in not holding that the $23,592.08 received by Wegener out of the joint account of Gant, Garvin and Wegener in excess of one third of the cost of drilling the wells was his capital assets and that the imposition of income tax upon it was the taxation of capital and that, because he was required to pay income tax on his share of the oil runs from the oil properties which repaid the money he had borrowed and paid into the joint account, a tax on that sum was a double taxation of it.

9. The Circuit Court of Appeals erred in not holding that the said sum of $23,592.08 was not includable in the income of the petitioner for income tax purposes and in not reversing the decision of the Board accordingly.

IV.
ARGUMENT

Synopsis of Argument

In support of the errors assigned the petitioner asserts and relies on the following propositions which will be presented and considered in order:

1. In Texas an oil and gas leasehold is an interest in the fee title to land and is real estate.

2. Gant, Garvin and Wegener owned their Rusk County, Texas, oil and gas leases as tenants in common, each owning an undivided one-third interest therein.

3. The joint operations of Gant, Garvin and Wegener in developing and operating the oil and gas leases which they owned as tenants in common constituted them a mining partnership.

4. An oil well is a permanent improvement upon and becomes a part of the land on which it is located and the cost of it is a capital investment of the owner in his land.

5. Assuming, contrary to the fact, that Gant, Garvin and Wegener were co-adventurers in a joint venture, and that their leases were not owned by them individually but were joint venture assets, still the $130,594.50 paid Wegener for drilling wells was paid out of capital assets of the joint venture paid in in cash by its members, and of which petitioner had paid in one third, and no part of his share in this paid in capital was gain or profit when repaid to him.

6. The character of an organization is not determined or affected by the name applied to it and bookkeeping methods and entries are not controlling as to the facts.

7. Section 801(a)(3) of the Revenue Act of 1934 merely defines the business organizations required to file an informational income tax return on a partnership form and does not convert every such organization into a legally constituted general partnership in respect of the relationship of the organization to its members and of the members to each other.

Proposition One

In Texas an oil and gas leasehold is an interest in the fee title to land and is real estate.

It is settled law in Texas by an unbroken line of decisions of its courts that an oil and gas lease conveys title to the oil and gas in place to the lessee and an interest in the fee title to the real estate and that such a leasehold is real property.

Cases which so hold are:

Stephens County v. *Mid-Kansas Oil & Gas Company*, 113 Texas 160, 254 S. W. 290.

Sibley v. *Pickens* (Tex. Civ. App.), 273 S. W. 897.

Stephens v. *Stephens* (Tex. Civ. App.), 292 S. W. 290, 294.

Dunn v. *Tennant* (Tex. Civ. App.), 82 S. W. (2d) 728.

The rule stated has been recognized and applied in the following cases involving the income tax laws of the United States:

Ferguson v. *Commissioner* (5th C. C. A.), 45 Fed. (2d) 573.

Chesson v. *Commissioner* (5th C. C. A.), 57 Fed. (2d) 420.

Hammonds v. *Commissioner* (10th C. C. A.), 106 Fed. (2d) 420.

In *Hammonds* v. *Commissioner*, *supra*, the Court said:

"Under the law of Texas oil and gas in place are part

of the realty and an oil and gas lease transfers to the lessee an interest in real estate."

Proposition Two

Gant, Garvin and Wegener owned their Rusk County, Texas, oil and gas leaseholds as tenants in common, each owning an undivided one-third interest therein.

The leaseholds involved were assigned by the Reliance Oil & Royalty Corporation and others to Walter H. Gant and Knox L. Garvin (R. 98). They assigned to Wegener as sole assignee in a separate instrument specifically *an undivided one-third interest in them.* In six different places this assignment recites that it conveys an undivided one-third interest, and further states that Wegener takes such undivided one-third interest charged with all the duties, obligations and liabilities imposed upon and assumed by Gant and Garvin in the assignment to them (R. 84, 85, 87, 88). It is elementary that where a conveyance of an undivided interest in real estate is made to one grantee, he can take such interest only as tenant in common with the other owners of that real estate. There is no other relationship possible between him and them.

In *Earp* v. *Mid-Continent Petroleum Corp.*, 167 Okla. 86, 27 Pac. (2d) 853, it is said:

> "The owners of undivided interests in the oil and gas rights in and under real estate are tenants in common."

And this is the law in Texas. *Peterson* v. *Fowler*, 73 Tex. 524, 11 S. W. 534; 11 Tex. Jur. 422, Sec. 14.

Proposition Three

The joint operations of Gant, Garvin and Wegener in developing and operating the oil and gas leaseholds which they owned as tenants in common constituted them a mining partnership.

The Board found as a fact that Gant, Garvin and Wegener did not agree or intend to form and did not form a partnership, and the Court below accepted this finding. The term "partnership" as thus used has reference to a general commercial or trading partnership. It is elementary that such a partnership cannot be formed without an agreement to form it, express or implied, by all its members. It never results by operation of law without such agreement. The evidence in this case is conclusive that Gant, Garvin and Wegener never agreed, expressly or by any implication, to form a general partnership or any kind of a partnership, but that, on the contrary, they expressly disavowed any such purpose, intention or agreement. So the finding that those men never formed a general partnership is correct.

Yet the Board and the Court below held as a conclusion of law that Gant, Garvin and Wegener were joint adventurers in the development and operation of the oil and gas leases which they owned as tenants in common and that their co-operation in that enterprise was a joint venture. But a joint venture is a species of partnership and has all the legal characteristics of a general partnership except that it is confined to the conduct of a single transaction or a single specific business undertaking. It can be formed for carrying out any single transaction or busi-

ness undertaking that may be carried on by a general partnership. *Like a general partnership, it can be formed only by agreement of its members and never results purely by operation of law without such agreement.*

In 15 R. C. L. 500, it is said:

> "A joint adventure generally relates to a single transaction. The usual test of a partnership as between the parties to a joint adventure is their intent to become partners."

In 33 C. J. 859, para. 59, it is said:

> "The members of a joint adventure have the power and interest of partners as to the disposition of the property involved in the enterprise, and, if the power to sell is not limited by the contract between or amongst them, a sale made by either or any member in good faith binds both or all of them."

There are literally scores of judicial definitions of a joint venture and while there are some variations in these in different jurisdictions, they are substantially in harmony. It would serve no useful purpose to present a great array of them. They are collected and cited in 4 Words & Phrases (1st Series) at pages 3814 *et seq.*; in 2 Words & Phrases (2nd Series) at pages 1232 *et seq.;* in 4 Words & Phrases (3rd Series) at pages 587 *et seq.;* and in 2 Words & Phrases (4th Series) at pages 464 *et seq.*

In *First Mechanics Bank* v. *Commissioner* (3rd C. C. A.), 91 Fed. (2d) 275, the Court said:

> "The concept of a partnership has been long established in the Common Law. Joint venture, as a legal concept, however, is of comparatively recent origin,

33 Corpus Juris, 841. It has been defined as a 'limited partnership; not limited in a statutory sense as to liability, but as to its scope and duration.' 4 Words & Phrases (1st Series), 3814. The relationship of a joint venture may exist where persons embark in an undertaking without entering upon the prosecution of the business as strict partners, but engage in a common enterprise for their mutual benefit. Each has the right to demand and expect from their associates good faith in all that relates to their common interests. * * *

"*Whether or not the parties to a particular contract have, as between themselves, created the relationship of a joint venture depends upon their intention.* 33 Corpus Juris, 845, Section 16; *Reid* v. *Schaffer*, 249 Fed. 553 (C. C. A. 6)."

There is no need to present more authorities to the same effect. *It is established that a joint venture, like a general partnership, is created only by intention and agreement of the parties and that, as to the specific transaction or undertaking which is the subject of the venture, the relation between the members themselves and between the members and third persons is precisely that of general partners.* This last is just what Gant and Garvin and Wegener did not want and did not intend and agreed they would not have.

The petitioner contends that in combining to develop and operate their oil and gas leases Gant, Garvin and Wegener by operation of law constituted themselves a *mining partnership*, and that the holding of the Board and the Court below *that they were a joint venture is contrary to the evidence and contrary to the law.*

A mining partnership has many features in common with a general partnership and a joint venture, but it has certain characteristics wholly distinct from and at variance with both. Some of its peculiar characteristics are:

(1) That it can exist only in the development and operation of a mineral property;

(2) That it results without agreement, by operation of law from the action of the parties in jointly developing their separately owned interests in the mineral property;

(3) That, considered as a business unit, it never owns the mineral property, but the members continue to own their several interests in it in their individual capacities as tenants in common;

(4) That a member may at any time sell and convey his interest in the mineral property without the consent of the others and such sale does not dissolve the partnership, nor does the death of a member dissolve it, but the purchaser or the personal representative or heir of a deceased member, by operation of law and without the consent of the others, becomes a member in the place of the seller or of the deceased member, as the case may be.

(5) That a member cannot sell, convey or encumber any interest in the mineral property other than his own.

(6) That if a member sells his interest in the mineral property, any profit or loss on the sale is his individually and other members do not participate therein.

The undisputed facts are that Gant, Garvin and Wegener were owners as tenants in common of equal undivided interests in these oil and gas leases; that they developed and operated them jointly and in co-operation as equal owners; that they never *agreed to be partners or joint adventurers in that undertaking and to have as to each other and to third persons the rights and obligations of partners in respect of that particular enterprise, which agreement was necessary to constitute them either a partnership or a joint venture; that on the contrary, they expressly agreed that they would not have the relationship of partners, even though limited to the particular enterprise of developing and operating those leases; but that they did agree to and did jointly work and operate their common mineral property for their common good.* These facts constituted them in law a mining partnership. This is the relationship between them that would exist under the law generally and that did exist under the law of Texas where the property was located and their business was carried on.

In 15 Am. & Eng. Ency. of Law 609, a mining partnership is defined as follows:

> "Where tenants in common of a mine unite and cooperate in working it, they constitute a mining partnership."

In 18 R. C. L. 1200, it is said:

> "Where the several owners of a mine unite in working it, they form what is termed a mining partnership, whether they are tenants in common, lessees, or owners in any other relation. * * * While a mining part-

nership may be created by the express contract of the parties, it may be inferred also from their acts; *it being necessary only—and this is essential—that the co-owners of the property unite in operating or working the mine.*"

In Thornton on the Law of Oil & Gas (4th ed.), Vol. 1, page 894, para. 355, it is said:

"If two or more owners of a mine unite in working it, without any partnership agreement, the act of working it together creates a mining partnership; and the same is true of two or more holding interests in a lease of mining property. * * * They form what is termed a mining partnership * * * but which has also some rules peculiar to itself, one of which is that one person may convey his interest in a mine and mining business without dissolving the partnership."

And on page 897, paragraph 357, of the same text, it is said:

"But where tenants in common co-operate in developing a lease for oil and gas, each agreeing to pay his part of the expense and to share in the profits on the leases, they constitute a 'mining partnership.' "

In Mills & Willingham on the Law of Oil & Gas, page 274, it is said:

"A mining partnership is not based upon any agreement, either express or implied, but arises from the relation of the parties independent of a purpose to form a partnership, and in spite of an express intention to the contrary, when two or more co-tenants unite and operate in the development and operation of a mine or a mining claim."

In 29 Tex. Jur. 698, para. 32, it is said:

> "Mining partnerships are recognized in Texas. To constitute such a partnership there must be not only a joint ownership of mining property, but also joint operation thereof; the relation is not created merely by sharing in the net profits of an enterprise. However, an express agreement between the partners is unnecessary; 'the rule is that a mining partnership arises by operation of law where co-owners work a mine.' "

In *Munsey* v. *Mills & Garritty*, 115 Tex. 469, 283 S. W. 754, there is an elaborate consideration of the law of mining partnerships and its application to the joint development of oil and gas properties in Texas. It is needless to quote at length from this case, because it is not only the leading case on the subject in Texas, but a leading case on the subject in all jurisdictions, and this Court will examine it. The holding of the case on the point here involved is stated in the syllabus as follows:

> "Where joint owners of an oil lease unite in operating the premises without any special agreement as to their relation, they constitute a mining partnership."

See also:

Wagner Supply Co. v. *Bateman*, 118 Tex. 498, 18 S. W. (2d) 1052.

Shell Petroleum Corp. v. *Caudle* (5th C. C. A.), 63 Fed. (2d) 296.

Childers v. *Neely*, 47 W. Va. 70, 34 S. E. 828, 49 L. R. A. 468.

Barrett v. *Buchanan*, 95 Okla. 262, 213 Pac. 734.

McKay v. *Kelly*, 130 Okla. 62, 264 Pac. 814.

The undisputed facts and the uniform rule of law, and particularly the law of Texas which is controlling here, conclusively establish that Gant, Garvin and Wegener were not a joint venture, but were a mining partnership, in the development of their oil and gas leases.

The peculiar features of a mining partnership are stated in 18 R. C. L. 1201 as follows:

> "A mining partnership is governed by many of the rules relating to ordinary partnerships, but it has some rules peculiar to itself. The principal distinction between it and an ordinary partnership is that in a mining partnership the *delectus personae*, or the right of a partner to say whether a new partner shall be admitted to the partnership, is absent. Another distinction is that the law does not imply any authority, either to a member of such partnership, or to its managing agent, to bind the individual members upon any evidence of indebtedness. A third distinction is that, whereas a sale by a partner in an ordinary partnership dissolves it and compels a winding up and settlement of the business, in a mining partnership such a sale does not effect its dissolution but it continues with the owners as newly constituted. Because of these features mining partnerships have been said not to be true partnerships, but rather a cross between tenancies in common and partnerships proper. From these principles it is clear that a member of a mining partnership may sell his interest therein to whomsoever he may without the knowledge or consent of his co-owners; and that thereby a new member is brought into the partnership without the consent of his associates; and may purchase interests in it or in other mines for his own benefit without being required to account to the partnership for the property. From this

it is obvious that no relation of trust and confidence is created by a mining partnership in respect to the individual interests of partners therein, provided, of course, there is no express contract that the purchase should be for the benefit of all. But one member of a mining partnership cannot, without the consent of his co-partners, convey any other interest in the mine than his own."

See also:

Thornton on the Law of Oil & Gas (4th ed.), Vol. 1, 889 *et seq.*

Mills on Oil & Gas (1926 ed.), 273 *et seq.*

Skillman v. *Lachman*, 23 Cal. 198.

Childers v. *Neely*, 47 W. Va. 70, 34 S. E. 828, 49 L. R. A. 468.

Kahn v. *Central Smelting Co.*, 12 Otto (102 U. S.), 641, 645.

Bissell v. *Foss*, 114 U. S. 252, 29 L. ed. 126, 5 Sup. Ct. 851.

Harris v. *Lloyd*, 11 Mont. 390, 28 Pac. 736.

In a mining partnership the mineral property is not owned by and is not assets of the partnership as a business unit, but the members own their respective interests in it in their separate and individual capacities.

In 29 Tex. Jur. 698, Sec. 32, it is said:

"Under a mining partnership, the mine is owned by the partners as tenants in common, and each is jointly and severally liable upon obligations incident to the development enterprise. Contrary to the rule prevailing in the case of trading partnerships, a mining copartner may sell his share to a third person without the consent

of his co-owners and without dissolving the partnership. Also, the 'estate' of a mining partner succeeds to his interest upon his death, and has the same relation to the other partners as would the deceased were he alive."

In *Adams* v. *Texhoma Oil & Refining Co.* (Tex. Civ. App.), 262 S. W. 139, 141, the Court says:

"As a general rule in mining partnerships the co-owners of the mine are partners only in the profits; the mine itself being owned by them as tenants in common rather than as partners."

Finally in *Munsey* v. *Mills & Garitty, supra*, the following statements, each supported by an array of authorities, are approved by the Court:

"In a mining partnership the mine is owned by the partners as tenants in common.

"But the individual interests of the partners in the mineral estate are not partnership assets.

"In a mining partnership, the ownership of the mine as cotenants allows one partner to sell his share to a third person without the consent of his copartner and without dissolving the partnership, since the profits follow the property."

So in the mining partnership of Gant, Garvin and Wegener each member individually and in his private right, owned an undivided one-third interest in the oil and gas leases which he had the right and power to sell and convey by title in fee simple absolute, without the knowledge or consent of the other members of that mining partnership and without disrupting the partnership.

It follows necessarily that the partnership as a business

unit never owned those oil and gas leases and never had any capital investment in them. Its function was to develop and operate jointly the separately-owned interests of the members in the mineral property, and its capital as such consisted only in the money and personal property paid in by the members for the purpose of enabling it to perform that function.

In Mills on Oil & Gas (1926 Ed.), 277, para. 186, it is said:

> "In a mining partnership the lease or mineral right is owned in common by the joint tenants and not by the partnership; accordingly, *the only social assets are the machinery and equipment used in operating it, the moneys received by the sale of the joint product, and the property bought with the common funds.*"

In the same text at page 280, para. 188, after stating that in a mining partnership the majority of members and interests control the business of the partnership, it is said:

> "But such control and management extends only to the social assets of the partnership. The interests in the lease itself, or in the mine, being the property of the cotenants and not of the partnership, the majority have no right to sell or dispose of any of the interest of any of the cotenants in such lease or mine."

Numerous cases are cited in support of the foregoing texts.

See also:

Thornton on the Law of Oil & Gas (3rd Ed.), Vol. 1, p. 528, para. 362.

Childers v. *Neely,* 47 W. Va. 70, 34 S. E. 828, 49 L. R. A. 468, 81 Am. State 777.

Blackmarr v. *Williamson*, 57 W. Va. 249, 50 S. E. 254.

Dougherty v. *Creary*, 30 Cal. 290, 89 Am. Dec. 116.

Hawkins v. *Spokane, etc., Co.*, 2 Idaho 970, 28 Pac. 433.

Edinger v. *Southern Oil Co.*, 69 W. Va. 34, 71 S. E. 266.

Doyle v. *Burns*, 123 Iowa 488, 99 N. W. 195.

It is established that in a mining partnership in the absence of some special agreement, not a necessary feature nor legal attribute of such partnership, the mineral property does not belong to and is not capital assets of the partnership as a business unit, but remains the separate and individual property of the members, and, therefore, the only capital investment and capital assets of a mining partnership are money contributed for the working of the mine and personal property acquired for that purpose.

Proposition Four

An oil well is a permanent improvement upon and becomes a part of the land on which it is located and the cost of it is a capital investment of the owner in his land.

The correctness of this propostion would seem self-evident. An oil well, like a building, a water well, a reservoir, landscaping and terracing or any other structure made for bettering and increasing the usable value or the market value of real estate, is a permanent improvement of such real estate. The cost of it is ordinarily a capital investment

in the property and not deductible as ordinary and necessary business expense in determining income tax liability.

Section 24(a)(2) of the Revenue Act of 1934, being the Act applicable to the year involved in this case, reads as follows:

> "Section 24(a) General Rule: In computing net income no deduction shall in any case be allowed in respect of—
>
> * * * * * * *
>
> "(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

This provision has appeared in identical language in practically all the Revenue Acts. The regulation on it under the 1934 Act is Article 23-2 of Regulations 86.

Whatever may be said with respect to a dry hole, it cannot be seriously argued that a producing oil well is not a permanent improvement or betterment made to increase the value of the property and estate on which located. This fact is fully recognized in all decisions on the subject.

We do not overlook the Treasury Regulation, Article 23(m)-16 of Regulations 86, which gives a taxpayer an option to elect in the first instance whether he will capitalize the intangible costs of drilling a hole for oil or will deduct those costs as ordinary and necessary business expense. But whether the intangible cost of the wells here involved, regardless of their ownership, has been expensed or capitalized is immaterial, for that question relates merely to the

owner's cost in the wells and does not change their character as permanent improvements on the land and capital assets to the owner.

The Board of Tax Appeals has uniformly held that the expense of drilling an oil well or a water well is a capital expenditure:

Consolidated Mutual Oil Co., 2 B. T. A. 1067.

Old Farmers Oil Co., 12 B. T. A. 203.

George W. Wetherbee, 20 B. T. A. 35.

Sunburst Oil & Ref. Co., 23 B. T. A. 829.

Monrovia Oil Co., 28 B. T. A. 335.

Phillip Diet, 7 B. T. A. 1948.

Now if an oil well is a permanent improvement upon and becomes a part of the land on which it is located, it belongs to the owner of that land, whether he has any cost or capital investment in it for income tax purposes or not. And the owners of the land on which a well is located own the well in the same interests and proportions as they own the land and the cost of it is a capital investment of each of them to the extent of the cost thereof paid by each. It follows that the amount paid for oil wells by each member of the joint enterprise of Gant, Garvin and Wegener out of their borrowed money was additional capital investment of each in his undivided interest in the leases and in those wells, and if this money had ever been a part of his capital investment in his interest in the partnership, it was by its application in payment on his separately-owned interest in the wells withdrawn from the partnership capital and distributed to him. But since it was a distribution from capital and not

from profits of the partnership, no part could be gain to the member receiving it.

Proposition Five

Assuming, contrary to the fact, that Gant, Garvin and Wegener were co-adventurers in a joint venture, and that their leases were not owned by them individually but were joint venture assets, still the $130,594.50 paid Wegener for drilling wells was paid out of capital assets of the joint venture paid in in cash by its members, and of which petitioner had paid in one third, and no part of his share in this paid in capital was gain or profit when repaid to him.

Obviously the mere return of all or part of the capital which the owner has paid into a depository or a fund or an enterprise cannot constitute gain or profit. Here Wegener's borrowed money was capital paid by him into the joint account of Gant, Garvin and Wegener and when he was paid out of that joint account for drilling the wells, he received back the distribution of a part of the very capital he had paid into it. There can no more be profit or gain to him in that transaction than there would be if he had placed his borrowed money on deposit in bank to his credit or in currency in his safety deposit box and thereafter had checked out part of his deposit or had abstracted part of the currency from his box. The Internal Revenue Acts impose a tax on income only. They do not, and properly cannot under constitutional provision, tax capital. In all the changing forms of investment a taxpayer has a right to the return of his capital tax free.

Where a taxpayer pays capital into a business enter-

prise, whether a joint venture or a mining partnership, and then, as compensation for services or for merchandise or other property, receives payment out of the capital which he has paid into the enterprise, he realizes no gain in the transaction, for the money paid to him is merely a return of his capital investment. If the payment to him was for services or for merchandise or property sold at a price above his cost therein, he would have a profit or gain to the extent that his services were paid for, or that his margin of sale price above cost was paid, out of the shares of other members in the capital assets of the organization. Of course, under such circumstances any payment made to him out of earnings of the organization would include profit and gain to the same extent, and to be determined in the same manner, as if he had dealt with an individual or corporation as the opposite party. But insofar as such payments result in the reduction of his capital investment in the partnership, they are not income or gain to him. This for the reason that he has merely transferred part of his capital investment out of a joint ownership with his partners into his individual ownership—has merely transferred money from one to another of his own pockets.

In G. C. M. 6582, C. B. VIII-2, 200, it is said:

> "To the extent that the excess amount withdrawn by a partner represents his personal capital investment it is capital investment of the partner and not taxable income, but to the extent that the excess amount withdrawn is chargeable to the other partner's capital account, it is taxable income to the partner receiving it although deductible by the partner from whose capital investment it is taken."

In *S. U. Tilton*, 8 B. T. A. 914, 917, it is said:

"A partner receiving a salary is merely transferring money from one to another of his own pockets.

* * * * * * *

"To hold that a salary paid by a partnership to one of its members *is income when received, regardless of whether such payment is made from capital or profits, may result in the taxation of capital.*"

To the same effect are:

Leo Schwartz, 7 B. T. A. 223.

Augustine M. Lloyd, 15 B. T. A. 82.

Melville W. Thompson, 18 B. T. A. 1192.

United States v. *Coulby* (D. C., N. D., Ohio), 251 Fed. 982.

United States v. *Coulby* (6th C. C. A.), 258 Fed. 27.

A partnership is not a taxable person or a legal entity for income tax purposes. Section 181 of the Revenue Act of 1932 and Section 181 of the Revenue Act of 1934 are identical in the following language:

"Individuals carrying on business in partnership shall be liable for income tax only in their individual capacities."

A partnership is merely a group of persons associated together for the transaction of business and as such is merely the agency, means or medium through which each member of the group individually transacts business and realizes individual gain and profit or sustains individual loss. This purpose of the group association of individuals is more

pronounced in a mining partnership than in a general partnership or a joint venture, for the members of a mining partnership retain separate and individual ownership of their respective interests in the mineral property which never becomes assets of the partnership, but of which the use only is contributed to the partnership. The only thing its members have in common is the money and personal property which they contribute to their group association for the purpose of jointly developing and operating their separately-owned interests in the mineral property. Yet with respect to income taxation every form of partnership is regarded as merely a group of persons associated together for the transaction of a business in which they own individual interests. Partnership income is not to be computed on an entity basis and the partnership treated as an independent business unit for the purposes of income taxation. True, returns called partnership returns are required of every kind of group of persons associated together in carrying on a business. But these are informational returns and their purpose is to enable the ascertainment of the amount of gain realized or loss sustained by each individual on account of his interest in the business operations of the group. This is established by the following authorities:

United States v. *Coulby* (D. C., N. D., Ohio), 251 Fed. 982.

United States v. *Coulby* (6th C. C. A.), 258 Fed. 27.

Craik v. *United States* (Ct. Cl.), 31 Fed. Supp. 132.

Carroll v. *Commissioner* (5th C. C. A.), 70 Fed. (2d) 806, 808.

Jennings v. *Commissioner* (5th C. C. A.), 110 Fed. (2d) 945.

Neuberger v. *Commissioner,* dec. Sup. Ct. U. S., Nov. 12, 1940, not yet off. rep., 61 Sup. Ct. 97.

Proposition Six

The character of an organization is not determined or affected by the name applied to it, and bookkeeping methods and entries are not controlling as to the facts.

In its opinion the court below said:

> "For reasons best known to themselves they chose to carry on their operations as a joint venture in the name of Gant, Garvin & Wegener with a joint banking account and a separate bookkeeping system. This method of doing business cannot at this late date be repudiated solely to avoid taxation" (R. 144).

We have elsewhere shown that "their operations" were as a matter of fact and law carried on as a mining partnership. It is true that in various instruments introduced in evidence their joint operations are sometimes named a partnership and sometimes a joint venture and the members are sometimes referred to as partners. But the name applied to their joint operations is neither controlling nor important in determining its correct legal nature. Their organization is such as the facts of what they agreed upon and what they did make it, and not what they may have called it.

In *Beecher* v. *Rusk,* 45 Mich. 188, 194, 7 N. W. 785, 40 Am. Rep. 465, Judge COOLEY quotes with approval from

Chancellor KENT in *Post* v. *Kimberly*, 9 Johns. (N. Y.) 470, 504, as follows:

> "The law must declare what is the legal import of their agreements, and names go for nothing when the substance of the arrangement shows them to be inapplicable."

And in literature as well as in law, it has been recognized, at least since Skakespeare's time, that names do not control or change substance. Witness the immortal words of Juliet in Scene II, Act II, Romeo and Juliet:

> "What's in a name? That which we call a rose,
> "By any other name would smell as sweet."

The petitioner never has repudiated his "method of doing business," and never has desired, and does not now desire, to do so, if he could. The method first used in 1932 was, as a matter of convenience, changed slightly in form, but not in effect, in September of that year. As thus changed it was accepted by the Bureau of Internal Revenue for the years 1932, 1933 and 1934 as correctly reflecting the expenditures upon and income from his separately-owned and jointly-operated one-third interest in the Rusk County, Texas, leases. In 1935 the Bureau repudiated its position in the three previous years and for the first time asserted that petitioner was making a profit in drilling wells for himself as well as in drilling wells for Gant and Garvin.

It is not disputed that the bookkeeping method of charging the full amount of the agreed footage price for drilling the wells to an account entitled "Gant, Garvin & Wegener" and then crediting a separate account called "Lease Investment Contra" with one third of the profit in

that price correctly reflected the facts and that petitioner's books thus kept showed that he did not realize a profit on his one third of the price of the wells. This is all that any bookkeeping method and any bookkeeping entries needed to show, for they do not create nor control facts. Their purpose is to record facts and furnish a source of information. They are at most evidential and are to be interpreted in the light of known facts and are overcome by facts otherwise established.

In the case of *In re Sheinman* (D. C., E. D., Pa.), 14 Fed. (2d) 323, the Court says:

> "The ascertainment of the amount of the net taxable income of the taxpayer is the ascertainment of a fact. Real facts and not bookkeeping entries give rise to income. Books of account are no more than evidential. They are neither indispensable nor conclusive. [Citing cases.]
>
> * * * * * * * * *
>
> "The decisions under the excise tax law and under the income tax law are uniform to the effect that the Government cannot base a claim for taxes on mere bookkeeping. [Citing cases.]"

In *Southern Pacific R. Co.* v. *Muenter* (9th C. C. A.), 260 Fed. 837, 838, the Court said:

> "A system of bookkeeping will not justify the Government in claiming taxes, nor would it justify the taxpayer in claiming exemption from taxation. The facts must control. [Citing cases.]"

In *Douglass* v. *Edwards* (2d C. C. A.), 298 Fed. 229, 234, the Court said:

"There is no question of good faith in regard to these entries; but it is well at the outset to realize that, in this case, the rights of the parties can neither be established nor impaired by the bookkeeping methods employed, or by the names given to the various items."

In *Doyle* v. *Mitchell Bros.*, 247 U. S. 179, the Court, commenting on book entries involved in that case, said:

"Nor is the result altered by the mere fact that the increment of value had not been entered upon plaintiff's books of account. Such books are no more than evidential, being neither indispensable nor conclusive. The decision must rest upon the actual facts, which in the present case, are not in dispute."

Proposition Seven

Section 801(a)(3) of the Revenue Act of 1934 merely defines the business organizations required to file an informational income tax return on a partnership form and does not convert every such organization into a legally constituted general partnership in respect of the relationship of the organization to its members and of the members to each other.

Section 801(a)(3) of the Revenue Act of 1934 reads as follows:

"SEC. 801. DEFINITIONS.

"(a) When used in this Act—

* * * * * * *

"(3) The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this Act, a trust or estate or a corporation; and the term 'partner' includes

a member in such a syndicate, group, pool, joint venture, or organization."

Supplement F of that Act deals with partnerships and comprises sections 181 to 188. Section 181 provides that:

"Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

It seems plain that the purpose of Section 801(a)(3) was merely to require each form of business organization defined therein to file a partnership informational return disclosing the net profit or loss to each member from the business he carried on through such organization.

It is not conceivable that Congress intended to break down all distinctions in respect of capital investments, property rights and ownership, and the legal relationship between the organization and its members and between the members themselves that exist between the designated organizations and a general partnership, and convert each of them into a general partnership and impose upon it and its members all the rules of law applicable to a general partnership and determine the net profits or losses to its members in all respects as though it were a general partnership. *United States* v. *Coulby* (D. C.), *United States* v. *Coulby* (6th C. C. A.), *Craik* v. *United States, Carroll* v. *Commissioner, Jennings* v. *Commissioner, Neuberger* v. *Commissioner, supra.*

Both the Board and the Court assert that the so-called joint venture capitalized the amount paid Wegener for drilling the wells as cost in its capital assets consisting of

the wells. *There is no fact foundation for this assertion.* The Board says:

> "It is true that the joint venture had a right to elect to treat 'intangible' development costs as ordinary and necessary expenditures in its income tax return, Regulations 86, art. 23(m)-16, but it did not do this. Obviously it elected to capitalize the entire development cost, and we see no reason for treating it otherwise" (R. 33).

The Court said:

> "Furthermore, the cost of drilling wells was capitalized, and Wegener and his associates will recover this cost by way of depletion as oil is produced from the lease" (R. 144).

The only basis for the foregoing is the fact in respect of the partnership form returns stated both by the Board (R. 29) and the Court (R. 142) in identical language as follows:

> "No deduction was taken on these returns for the cost of drilling oil wells, or for any amount paid out for such drilling."

The position of petitioner and his associates was that the joint enterprise as a separate business unit never owned the oil and gas leases and never paid for drilling wells on those leases and never owned the wells after they were drilled, but that the leases and the wells at all times belonged to the three of them as co-owners in undivided one-third interests. On this theory it would have been improper and incorrect for any deduction for the cost of drilling wells to have been taken as expense on the returns

filed on a partnership form. The fact is that no deduction for intangible drilling costs was taken on the partnership form of return, not because such costs were treated as capitalized cost of partnership wells, but because the wells were not partnership wells and the drilling of them was not partnership expense and hence *such expense could not be deducted on the partnership form of return.*

The cost of these wells was the expense of the three individuals who owned them as tenants in common and, whether expensed or capitalized, was for them to determine on their respective individual returns. So far as the so-called joint venture was concerned, it merely distributed to its members $130,594.50 of their paid in capital.

It does not appear from anything in the record, and is not material here, whether Wegener capitalized or expensed the intangible drilling costs of an undivided one-third interest in the wells. If he did capitalize it, the only amount of allowable cost therein would be what he *actually paid for drilling a one-third interest in them* and would not include the fictitious profit of $23,592.08 which he never spent on them.

Let us assume that in 1935 Wegener alone owned an oil and gas leasehold which he desired to develop. He estimated that it would cost $75,000 to drill the wells he wanted and borrowed that sum from a bank to cover such estimated cost. Within the year he drilled the wells, but they cost only $50,000. No one, not even the Commissioner or anyone connected with his office, would have the hardihood to say that the unused $25,000 of borrowed money was

profit to him; that he was required to include it in income on his return and pay tax on it; and that then he might add it to the $50,000 as capital invested in the wells and expect to get it back tax-free through depletion allowances. How could it be cost or capital investment in the wells when not a cent of it was spent on them?

Yet in the instant case, the Commissioner, the Board and the Court below have said what amounts to the same thing on a slightly varied, but not substantially different, state of facts. The sole and only factual difference between the supposed case and this one is that here Wegener, instead of owning an entire leasehold, owned an undivided one-third interest in it, and that instead of borrowing the money to develop it alone, he joined with the owners of the two-thirds interest in borrowing the money, and when the wells were drilled he had spent less than his one third of the money borrowed for drilling them, because he had saved cost by doing the work himself, although the other owners had spent all of their two thirds of the borrowed money, because they hired their two thirds of the work done. How can the borrowed money that he saved on his share of the cost of the wells by doing the work himself be profit and taxable gain to him and cost or capital investment in the wells?

The Board and the Court below have avoided the obvious answer to this question by saying that the three owners of the leasehold constituted a species of partnership called a joint venture and that this was a legal entity or a business unit or a thing apart from its members, and as

such owned the leaseholds and contracted for drilling its own wells on them and paid for these wells out of its own funds without regard to the source of those funds.

This violates the most fundamental and distinguishing characteristic of a mining partnership and is in fact in complete disregard of the fundamental legal concept of a general partnership or of a joint venture.

The Court below distinguishes its decision in *Ortiz Oil Company* v. *Commissioner* (5th C. C. A.), 102 Fed. (2d) 508, from the instant case (R. 144). There the owner of a half interest in a lease drilled a well under an agreed price therefor with the other owners. They paid him their one half of this agreed price and it was held that the excess of the amount so paid over one half his cost in the well was income and profit, but that he did not realize a profit on the drilling of his half of the well measured by the difference between half his actual cost and half the agreed price. The Court below says that that case applies to the arrangement between Wegener and Gant and Garvin for the year 1932. So if Wegener had drilled the wells and paid the entire cost thereof out of his personal funds and then collected from Gant and Garvin the difference between the agreed price and two thirds of the cost, he would not have been charged with a profit on his one-third interest in the wells measured by the difference between one third of the cost and one third of the agreed price. But the Court says that a new method was adopted after 1932 and that this changed entirely the position of Wegener in respect of the drilling of the wells. The only change was that

instead of the accounts of the individuals being handled separately and the payments each was obligated to make being made separately, they combined them in a joint account of which each paid in one third, and then each paid his part of the cost out of that joint account. Wegener paid himself for his one third of the wells out of his one-third interest in this joint account. To say that he realized a profit on the amount he thus paid himself is to sacrifice substance for form. Taxable income is not created by methods of handling accounts or of keeping books, but arises only from the ultimate fact that a taxpayer has made a profit or gain—has acquired something he did not have before.

CONCLUSION

For his conclusion to this brief the petitioner adopts the following from the dissenting opinion of Judge HUTCHESON in the Court below:

> "Looked at realistically, that is, as the facts are, Gant, Garvin and Wegener represent merely a name and device through which petitioner and his associates conducted the business of drilling on and operating their properties. The substance of the matter at all times was that the properties were owned by the three as co-owners, the development was paid for by the three as co-owners, and the returns from the oil runs were paid individually to each of the three as co-owners. Under these facts, Wegener as to the $23,592.08 in question, was merely being repaid advances he had made to the joint venture and it would be a denial of everything that has been written and said in taxing statutes and decisions, relating to and affecting

partners and partnerships and their return and payment of income taxes, to treat this sum as income" (R. 150).

The petitioner asks that this Court grant the writ of certiorari as prayed for and review the decision of the Court below.

Respectfully submitted,

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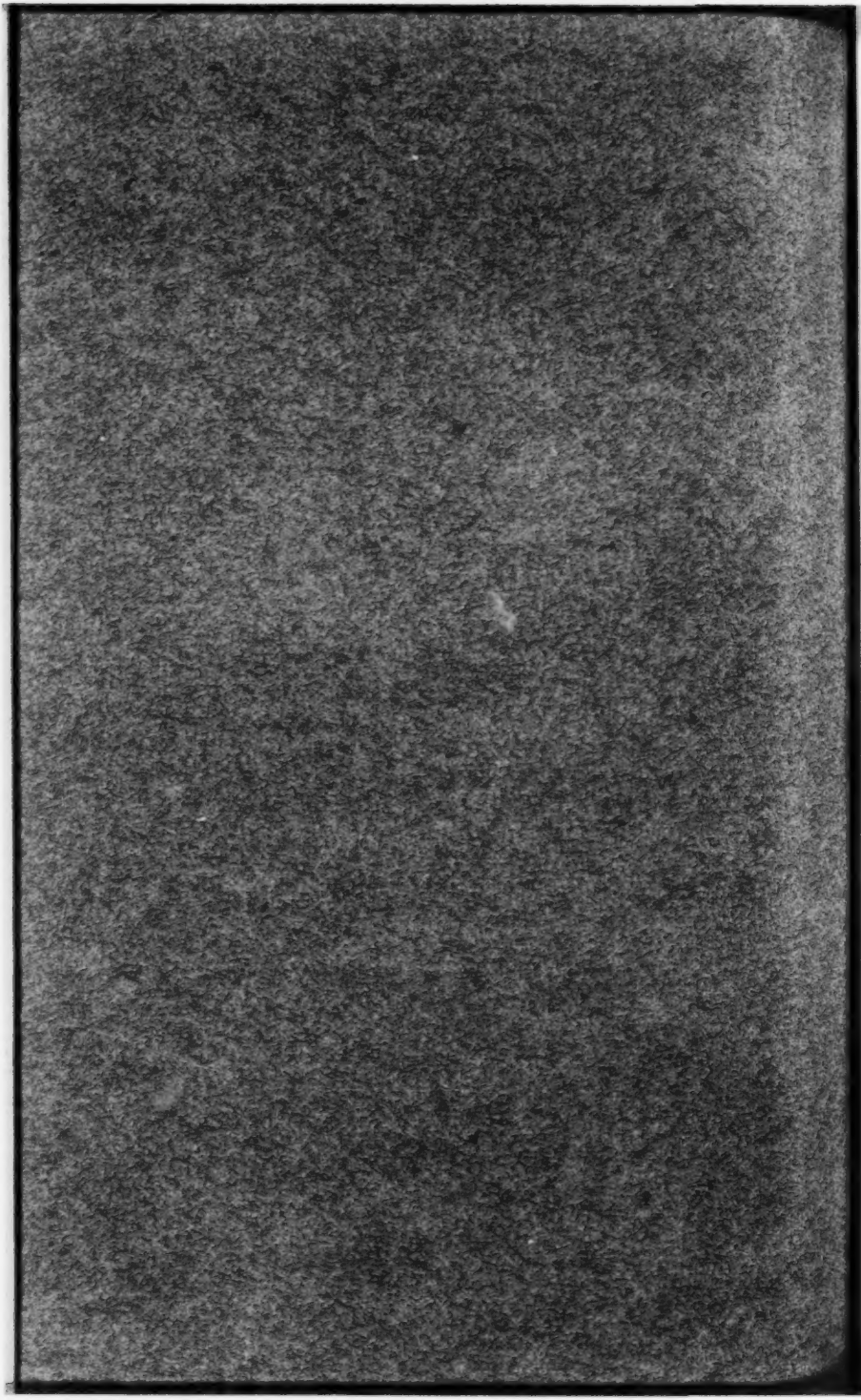

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In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 225

H. H. WEGENER, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 25–34) is reported in 41 B. T. A. 857. The opinion of the Circuit Court of Appeals (R. 139–151) is reported in 119 F. (2d) 49.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 7, 1941 (R. 151). The petition for a writ of certiorari was filed on June 30, 1941. The jurisdiction of this Court is invoked under

Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer engaged in a business undertaking with two other individuals under an arrangement which constituted the venture a "partnership" within the definition of Section 801 (a) (3) of the Revenue Act of 1934. The question is whether the entire net proceeds received by the taxpayer in payment for services rendered to the "partnership" are taxable income, or whether one-third (the proportion of the taxpayer's interest in the undertaking) should be excluded.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra,* pp. 8–11.

STATEMENT

The pertinent facts, found by the Board of Tax Appeals and accepted by the Circuit Court of Appeals, may be summarized as follows:

In 1932 Walter H. Gant and Knox L. Garvin acquired an interest in certain oil and gas leases. They entered into an agreement with the taxpayer that he would take a one-third interest in the leases and drill wells on the property at an agreed price. Since the taxpayer expressed an unwillingness to enter into a partnership, no partnership agreement was signed. Gant and Garvin, however, assigned to him an undivided one-third of their interest, and

he assumed one-third of all their obligations in connection with its acquisition (R. 26–27).

The enterprise was conducted in the name of Gant, Garvin & Wegener (R. 27–28). The taxpayer undertook the drilling of the wells, and beginning with the latter part of 1932 charged Gant, Garvin & Wegener for the work at a specified price (R. 28). Payments were made from funds borrowed from banks (R. 28–29). These loans were secured by a deed of trust executed by the taxpayer and Gant and Garvin "as individuals and as partners" (R. 27–28).

Gant, Garvin & Wegener filed a partnership return on Form 1065 for the year 1935 (as well as for the prior years 1932, 1933, and 1934) showing gross profits of $174,609.15. No deduction was taken on the partnership returns for the expenses incurred in drilling oil wells, or for any amounts paid out for such drilling (R. 29).

The taxpayer, in his personal return for 1935, reported his *pro rata* share of the partnership income. During this year, however, he had also received $130,594.50 for drilling operations, which, after deducting expenses of $59,818.27, left a net profit of $70,776.23. He returned as income only two-thirds of the sum (i. e., the proportion corresponding to Gant's and Garvin's interests in the enterprise) (R. 29).

The Commissioner determined that the entire amount was taxable income. The court below

affirmed the decision of the Board of Tax Appeals sustaining this determination.

ARGUMENT

The question presented was correctly decided by the court below,[1] and is not in conflict with the decisions cited by the taxpayer.

1. Both the court below and the Board of Tax Appeals recognized that it was immaterial to the determination of the tax question whether Gant, Garvin & Wegener was a "joint venture," as the Board found, or a "mining partnership," as the taxpayer claims. The pertinent fact (which is not denied) is that Gant, Garvin & Wegener was a "partnership" within the definition of Section 801 (a) (3) of the Revenue Act of 1934, and was required to file a partnership return under Section 187 of the Act. Consequently, the taxpayer's taxable income would consist of his individual income

[1] The court rejected the Government's contention that the proceedings should be dismissed for want of jurisdiction. The contention rested on the grounds that no petition for review had been timely filed with the appropriate Circuit Court of Appeals under Section 1141 (b) (1) of the Internal Revenue Code, and that the stipulation, pursuant to Section 1141 (b) (2) of the Code, which designated the Circuit Court of Appeals for the Fifth Circuit as the court to review the Board's decision, had not been filed within the time allowed for filing a petition (R. 127–129). The Government, while entering into the stipulation, had reserved the rights to question its timeliness and legal effect and to question the court's jurisdiction (R. 126). The Government intends to raise these questions before this Court if the taxpayer's petition for certiorari should be granted.

and of his distributive share of the net income of the partnership computed, for purposes of the revenue laws, as the income of separate business entities. Revenue Act of 1934, Sections 182, 183, 187.

Consistently with the statute, therefore, the entire payment made by the "partnership" to the taxpayer for the drilling operations represented development costs to the former and income to the latter, as held by the court below. Nowhere in the statute is there a basis for contention that the payments should be treated as a *pro tanto* return of capital, or that the separate entities, for purposes of computing the tax liability, should otherwise be disregarded.

2. Appropriate adjustment for the circumstance that the proportion of the income received by the taxpayer corresponding to the proportion of his interest in the partnership represents in a sense his own funds is made in the computation of the partnership income. The "partnership" was entitled either to deduct the drilling payments made to the taxpayer as an ordinary expense or to capitalize those payments and recoup them through depletion. Sections 23 (m), 183, Regulations 86, Article 23 (m)–16. Cf. *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90, 95. Whichever option was taken the result would be reflected in the reduction of the partnership's net income and accordingly in the taxpayer's distributive share, thus offsetting the payments computed as individual income to the taxpayer.

Since in the instant case the payments had not been deducted as ordinary expense during the taxable year, the Board of Tax Appeals found that they had been capitalized (R. 33) and the court below agreed with this conclusion (R. 144). The result is that the proportion of the payments representing the taxpayer's interest will be returned to him by a reduction of the partnership's future net income through its depletion allowance. Regulations 86, Article 23 (m)–16 (b) (1). By the same token, none of the sums paid the taxpayer constitute a present distribution of partnership capital.

3. In *Neuberger* v. *Commissioner*, 311 U.S. 83, it was held that under Section 23 (r) (1) of the Revenue Act of 1932 a taxpayer could deduct from his share of partnership income derived from the sale of securities which were not capital assets, losses sustained on similar transactions. The basic question decided by the Court was that the distributed income retained in the hands of the individual partners the characteristics which it had when received by the partnership. The decision of the court below is not in conflict, since the instant case presents the substantially different problem of the taxability to a partner of funds which he has received for personal services performed for the benefit of the partnership.

4. The *Neuberger* case resolved a conflict between the lower court's decision in that case and

Jennings v. *Commissioner,* 110 F. (2d) 945 (C. C. A. 5th), and an asserted conflict with *Craik* v. *United States,* 31 F. Supp. 132 (C. Cls.). A similar question was presented in *United States* v. *Coulby,* 258 Fed. 27 (C. C. A. 6th). *Carroll* v. *Commissioner,* 70 F. (2d) 806 (C. C. A. 5th), also decided by the court below, involved the basis for depletion of partnership assets where the interests of the partners had been acquired at different times. It is evident that none of these cases relied on by the taxpayer establishes a conflict among the circuits, nor does a conflict otherwise appear.

CONCLUSION

The petition should be denied.

Respectfully submitted.

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SAMUEL O. CLARK, JR.,
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SEWALL KEY,
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JULY 1941.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. (U. S. C., Title 26, Sec. 23.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. (U. S. C., Title 26, Sec. 181.)

SEC. 182. TAX OF PARTNERS.

There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year. (U. S. C., Title 26, Secs. 182, 188.)

SEC. 183. COMPUTATION OF PARTNERSHIP INCOME.

The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual. (U. S. C., Title 26, Sec. 183.)

SEC. 187. PARTNERSHIP RETURNS.

Every partnership shall make a return for each taxable year, stating specifically

the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners. (U. S. C., Title 26, Sec. 187.)

SEC. 801. DEFINITIONS.

(a) When used in this Act—

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(3) The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this Act, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

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(U. S. C., Title 26, Sec. 1696.)

Treasury Regulations 86 (1934 Ed.):

ART. 23 (m)–16. *Charges to capital and to expense in the case of oil and gas wells.*— (*a*) Items chargeable to capital or to expense at taxpayer's option:

(1) Option with respect to intangible drilling and development costs in general: All expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas, may, at the option of the taxpayer, be deducted from gross income as an expense or charged to capital account. Such expenditures have for convenience been

termed intangible drilling and development costs. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used (A) in the drilling, shooting, and cleaning of wells; (B) in such clearing of ground, draining, road making, surveying, and geological work as are necessary in preparation for the drilling of wells; and (C) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas. In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the purpose of this option labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Drilling and development costs shall not be excepted from the option merely because they are incurred under a contract providing for the drilling of a well to an agreed depth, or depths, at an agreed price per foot or other unit of measurement.

(2) Option with respect to cost of nonproductive wells: In addition to the foregoing option the cost of drilling nonproductive wells at the option of the taxpayer may be deducted from gross income for the year in which the taxpayer completes such a well or be charged to capital account returnable through depletion and depreciation as in the case of productive wells.

(3) If deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been

included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.

(*b*) Recovery of optional items, if capitalized:

(1) Items returnable through depletion: If in exercising these options, or either of them, the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized in so far as they are not represented by physical property, are returnable through depletion. For the purposes of this article the expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion.

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U. S. GOVERNMENT PRINTING OFFICE : 1941